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Valuation & Litigation

BRIEFING

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Tax Court to valuers: Explain yourself!

The U.S. Tax Court's opinion in *Estate of Gallagher* is instructive for both attorneys and valuation experts. It demonstrates the court's inclination to scrutinize expert testimony and demand that experts thoroughly explain the reasoning behind their valuation assumptions and adjustments.

The case

The only issue to be decided in this case was the fair market value for estate tax purposes of the decedent's 15% ownership interest in Paxton Media Group, LLC (PMG). A privately held, family-owned newspaper publishing company, PMG was originally established in 1896, elected to become an S corporation 100 years later, and converted to a limited liability company (LLC) in 2001 (but maintained its "S" status for tax purposes). The decedent died on July 5, 2004 (the valuation date).



At trial, the estate's expert valued the decedent's interest at \$28.2 million, while the IRS's expert valued it at \$40,863,000. In a 53-page opinion, the Tax Court parsed the experts' valuation reports, often rejecting their methods or assumptions as unsupported or inadequately explained. The court made its own determination of value: \$32,601,640.

Discounted cash flow method

The estate's expert relied primarily on the discounted cash flow (DCF) method, while the IRS's expert applied both the DCF and guideline public company methods. One issue involved adjustments to the company's income statements in calculating the earnings stream used under the DCF method. Both experts excluded certain income items they claimed were nonrecurring.

Among other things, the estate's expert excluded a \$700,000 gain from a life insurance policy obtained through an acquisition along with a \$1.1 million "positive claim experience" from the company's self-insured health insurance. The Tax Court disregarded these adjustments because the expert "provide[d] no explanation as to why the gains were nonrecurring."

In addition, the estate's expert made adjustments to reflect an overfunded pension plan that, he said, "increased the company's reported net income" in most years. He eliminated the pension amounts from the company's historical financial statements, "adding back the 'full amount of the overfunding,' \$11,664,000, to PMG's enterprise value."

The court rejected this adjustment as well, finding that the expert "failed adequately to explain both his \$11,664,000 calculation and the reason for assuming the overfunded plan provided no annual benefit under the [DCF] method." It went on to say,

“Because we fail to understand his adjustments, we shall disregard them.”

The opinion contains a lengthy discussion of the DCF method, focusing on the experts’ revenue growth computations, adjustments and discounts. In general, the Tax Court found the IRS expert’s analysis more persuasive and adopted it with certain modifications.

The court found several flaws in the estate expert’s analysis. For example, he selected a growth rate that was significantly higher than the company’s historical growth rate. He also adjusted his projections to account for expected increases in newsprint costs, but failed to explain how he arrived at the projected costs.

Guideline company method

The Tax Court found that the IRS’s expert improperly relied on the guideline company method. Under that method, an expert values the subject company by comparing it to similar public companies. In this case, the IRS’s expert analyzed only four public companies, and the court found that they weren’t sufficiently comparable to PMG to warrant application of this valuation method.

Generally, the less similarity there is between the guideline companies and the subject company, the greater the number of comparables required. Among other differences, PMG was substantially smaller than the guideline companies, had a different product mix, experienced greater revenue growth and was more highly leveraged.

Tax affecting projected earnings

In applying the DCF method, the estate’s expert “tax affected” PMG’s projected earnings — that is, he reduced the company’s projected earnings to reflect an assumed corporate tax burden. (See “To tax affect or not to tax affect” at right.)

The Tax Court, however, declined to tax affect PMG’s projected earnings because the estate’s expert failed to offer a reason for doing so. The expert had reduced projected earnings based on an assumed

TO TAX AFFECT OR NOT TO TAX AFFECT

The tax affecting in question in *Estate of Gallagher* (see main article) is somewhat controversial. Even though S corporations don’t pay corporate level income taxes, valuers would routinely tax affect projected S corporation earnings at a C corporation equivalent rate, which allows the value derived from the income approach to be consistent with the required rate of return derived from publicly traded companies (for example, both on an after-tax basis).

In addition, the corporation could:

- ◆ Lose its S status (for example, by being acquired by a C corporation), or
- ◆ Fail to distribute sufficient income to cover its shareholders’ tax liabilities.

In 1999, however, the Tax Court ruled in *Gross v. Commissioner* that tax affecting was *inappropriate* in valuing a minority interest in an S corporation. The court explained that the primary benefit of S corporation status is the absence of corporate-level taxes, a benefit that shouldn’t be ignored in determining its value.

That doesn’t mean that tax affecting is never justified — in *Gross*, the court was influenced by the lack of evidence that the corporation in that case was likely to lose its S status. In fact, many valuation experts believe that tax affecting continues to be appropriate if there’s a good reason for doing so.

39% tax rate, so the court’s decision had a significant impact on the value calculation.

Back it up

As the *Gallagher* case shows, courts today no longer accept valuation experts’ opinions without careful scrutiny. Unless your experts can back up their conclusions with convincing reasons, you run the risk that the Tax Court will conduct its own valuation analysis. ◆

Estimating a defendant's profits in IP cases

In certain types of intellectual property (IP) litigation, plaintiffs are entitled to recover (in addition to or in place of their own lost profits) damages based on the profits the defendant enjoyed as a result of its infringement. Generally, this measure of damages is available in cases involving nonpatent IP (such as copyrights, trademarks and trade secrets), as well as certain design patents.

The theory behind awarding an IP owner the infringer's profits is straightforward: 1) It prevents the defendant from being unjustly enriched by its wrongful act, 2) it deters infringement by making it unprofitable, and 3) it ensures that the plaintiff is fully compensated even if its own lost profits are difficult or impossible to prove. Estimating these damages, however, can be a challenge.

Apportioning sales

The IP owner has the burden of proving the defendant's gross sales of infringing products. Then the burden shifts to the defendant to prove, if possible, that a portion of its sales were attributable to factors other than the infringement.

For example, an infringer may have the ability to generate greater sales than the plaintiff as a result of a stronger sales force, superior distribution channels or better pricing. In addition, the quality of the infringing product may be enhanced by features supplied by the defendant.

Apportioning sales among infringing and noninfringing activities can be difficult. In some cases, the impact of infringement on sales is more readily quantified.

Suppose, for instance, that an IP owner sues a company for infringing its trademark in print ads. If the defendant uses the infringed trademark in 25% of its ads (assuming that all of the ads are similar in terms of location

and readership), then one might argue that 25% of the defendant's sales resulting from the ads are attributable to

the infringement. On the other hand, the IP owner may argue that the infringing content's impact on sales was disproportionate to its frequency of use.

Often, the impact of infringement on sales is more *qualitative*. Say a defendant publishes a compilation of 30 short stories that contains one story published without the copyright owner's permission.

One story may be a small component of the overall work but, if it was written by a prominent author and the other stories are by lesser known authors, the infringing work may be the predominant factor driving the defendant's sales.

Financial experts can use a variety of techniques to quantify apportionment of sales, including market surveys; analyses of the defendant's revenues and profits before and after the infringement; and comparisons of infringing sales with the defendant's sales of similar, noninfringing products.



Allocating costs

The defendant also bears the burden of proving which costs should be deducted from infringing sales to arrive at lost profits. Unfortunately, IP law doesn't explicitly define lost profits, and costs are treated differently from court to court.

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Some courts allocate a percentage of a defendant's total costs (both fixed and variable) to infringing sales. The percentage is typically based on a ratio, such as total costs to total sales. Other courts

apply an incremental approach — that is, they permit the defendant to deduct only the increased cost that's directly attributable to production of the infringing product.

The distinction is critical because the incremental approach produces significantly larger damages awards. Some courts reserve the incremental approach for cases of willful infringement.

Gaining an advantage

Whether you represent a plaintiff seeking to recover an infringer's profits or a defendant trying to minimize its exposure, it's to your advantage to involve a financial expert in the case as early as possible. In addition to evaluating damages issues, an expert can help you draft discovery requests designed to elicit financial records and other evidence that supports your damages calculation. ♦

The perfect exit strategy

Don't let your clients leave it to chance

At some point in time, every business owner will retire and either sell his or her ownership interest or leave the company to others. The key to a seamless transfer is to identify an exit strategy that addresses the needs of not only the departing owner, but also the company in question.

Map the course

A well-planned exit strategy can help owners extract cash from their businesses, addressing a variety of transfer scenarios. These may include voluntary transfers such as retirement, gifts to

family members, donations to charities, stock compensation plans for managers, or mergers or acquisitions. They may also include involuntary transfers such as death or disability, divorce, partner/shareholder disputes, bankruptcy or restructuring, or natural disasters.



Business owners often overlook the possibility of unexpected events. But, as you know, operating a business without a contingency plan is like driving blindfolded: Things are fine as long as the road is straight and predictable. But when conditions change, a business owner can often run into trouble.

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Keep it real

The optimal exit strategy depends on the transfer scenario along with the owner's personal needs and objectives. Exit planning starts with number crunching but should also include some soul searching. Beyond the numbers, what else does an owner hope to achieve when he or she leaves the company?

Many owners dream of having their children run the show after they leave. But, in reality, their children may be incapable of managing the company — or

uninterested in taking the reins. In any event, it's in the owner's best interest to maintain control until a viable and workable plan can be executed.

Understand their options

Once goals are set, the owner needs to evaluate which alternatives meet his or her short- and long-term needs. Some of the most common exit strategies for private businesses include:

- ◆ Buy-sell agreements, which can provide liquidity upon the owner's retirement or an unexpected "triggering" event (such as death),
- ◆ Gifts and inheritances, which work well for owners seeking to transfer ownership to relatives or a worthy charity,
- ◆ Related-party sales to employees via an employee stock ownership plan (ESOP) or to other potential buyers such as suppliers, customers and competitors,
- ◆ Mergers or acquisitions with unrelated buyers, and
- ◆ Public offerings.

When it comes time for your clients to weigh exit strategy alternatives, work with a qualified business valuation expert. He or she can appraise assets

for gift and estate tax returns, provide insight into buy-sell provisions, evaluate the tax consequences of various exit strategies, consult on a merger or acquisition, or prepare fairness opinions for high-profile transactions.

Prepare for the changeover

If your client chooses to put the business up for sale, it's critical to get the business in "move-in" condition. So, make sure your client obtains accountant-prepared financial statements and implements a



strong system of internal controls that includes mandatory vacations, as well as separation of duties.

Also, to ease the transition to new management, your client should formally document job descriptions, update the organizational chart, train and retain second-generation managers, and bring business plans and financial forecasts to the negotiation table.

Work with the pros

If you have clients who have indicated a desire to retire or sell their businesses, be sure to retain a valuation professional. He or she can provide many services that can help an owner determine his or her financial needs when it's time to retire and smoothly transition out of the business. ♦

A FINANCIAL EXPERT'S ROLE IN EMPLOYMENT LITIGATION

Financial experts play a critical role in wrongful termination cases and other types of employment litigation — particularly in estimating damages. Key areas in which experts can get involved include:

Calculating base earnings. The expert must consider nonrecurring payments, seasonal fluctuations and other factors that affect the calculation of base pay. And if the plaintiff is unemployed for an extended time, the expert may need to project base pay for post-termination periods. This involves analyzing historical earnings, employer practices, industry or government information, and inflation data to select an appropriate earnings growth rate.

Valuing benefits. A sizable portion of an employee's total compensation comes from benefits, which include health coverage and retirement plans, as well as smaller perks, such as company cars and clothing allowances. Identifying benefits and estimating their value is a critical and challenging part of the damages calculation.

Determining the loss period. The loss period — which can range from several months to the plaintiff's entire work life — has a significant impact on the amount of damages. Selecting an appropriate period requires analyzing a variety of factors, including the plaintiff's likelihood of securing comparable employment and the need for specialized training to qualify for a new job.

Evaluating mitigation opportunities. Typically, a plaintiff is required to mitigate his or her damages in employment cases. If the plaintiff hasn't found another job by the time of trial, the financial expert will estimate the compensation the plaintiff could reasonably have earned by taking another job.

Discounting to present value. Once the expert determines lost earnings and the loss period, he or she will select an appropriate interest rate (often based on local statutory or case law) to discount projected earnings to present value.

Calculating damages in employment litigation is a complex task. That's why it's a good idea to retain a qualified expert early in a case to weigh your options and evaluate your evidentiary needs.

